



DEPARTMENT OF  
**FINANCE**

ARNOLD SCHWARZENEGGER, GOVERNOR

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November 10, 2008

Mr. David A. Gilb, Director  
Department of Personnel Administration  
1800 15th Street  
Sacramento, CA 95814-6614

Dear Mr. Gilb:

**Final Report—Savings Plus Plans, 2007 Financial Audit**

The Department of Finance, Office of State Audits and Evaluations (Finance), has completed its financial audit of the Department of Personnel Administration (Department), Savings Plus Plans for the year ended December 31, 2007.

The enclosed report is for your information and use. The Department's response to the report finding is incorporated into this final report. The Department agreed with our observation and we appreciate its willingness to implement corrective actions. The observation in our report is intended to assist management in improving the effectiveness and efficiency of its operations.

In accordance with Finance's policy of increased transparency, this report will be placed on our website.

We appreciate the assistance and cooperation of Department management and staff. If you have any questions regarding this report, please contact Richard R. Sierra, Manager, or Osman Sanneh, Supervisor, at (916) 322-2985.

Sincerely,

***Original signed by:***

David Botelho, Chief  
Office of State Audits and Evaluations

Enclosure

cc: Ms. Michelle Berklacich, Administrator, Savings Plus Program, Department of Personnel Administration

# A F<sub>INANCIAL</sub> S<sub>TATEMENT</sub> A<sub>UDIT</sub>

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Department of P<sub>ERSONNEL</sub> A<sub>DMINISTRATION</sub>

S<sub>AVINGS</sub> P<sub>LUS</sub> P<sub>LANS</sub>

F<sub>OR</sub> THE C<sub>ALENDAR</sub> Y<sub>EAR</sub> E<sub>ND</sub>ED

D<sub>EC</sub>EMBER 31, 2007

Prepared By:

Office of S<sub>TATE</sub> A<sub>UDITS</sub> AND E<sub>VALUATIONS</sub>

D<sub>EPARTMENT</sub> OF F<sub>INANCE</sub>

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This report is also available on our website at <http://www.dof.ca.gov>

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## Background

The Department of Finance, Office of State Audits and Evaluations (Finance), performed this audit under an interagency agreement with the Department of Personnel Administration (Department). The purpose was to audit the Savings Plus Plans' Statements of Net Assets Available for Benefits and Changes in Net Assets Available for Benefits for the calendar year ended December 31, 2007. The audit objectives were to:

- Express an opinion on the financial statements based on our audit conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.
- Verify that the financial statements were prepared in conformity with generally accepted accounting principles for savings plans.
- As necessary, report on internal control and compliance weaknesses, and provide recommendations for improving controls over the Plans' operations. This assessment also included activities of the Plans' external record-keeper and custodian/trustee.

## Audit Results

- Except for the unavailability of information regarding the allocation of investment earnings and change in fair value of investments to the individual Plans, the aforementioned financial statements are fairly presented for the year ended December 31, 2007.
- There was an internal control weakness regarding the Plans' financial reporting, as described in the Finding and Recommendation section of this report. Additional suggestions for improving the Plans' oversight and operations were separately reported to the Department.

This report is intended solely for the information and use of Plan stakeholders and is not intended to be used by anyone other than these parties. However, this report is a matter of public record and its distribution is not limited.



## INDEPENDENT AUDITOR'S REPORT

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Mr. David A. Gilb, Director  
Department of Personnel Administration  
1800 15th Street  
Sacramento, CA 95814-6614

We have audited the *Statement of Net Assets Available for Benefits* of the Department of Personnel Administration (Department), Savings Plus Plans (Plans) as of December 31, 2007, and the related *Statement of Changes in Net Assets Available for Benefits* for the year then ended. The Plans' financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following two paragraphs, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Finance is not independent of the Department, as both are part of the State of California's Executive Branch. As required by various statutes within the California Government Code, Finance performs certain management and accounting functions. These activities impair independence. However, sufficient safeguards exist for readers of this report to rely on the information contained herein.

We were unable to obtain sufficient evidence for the allocation of investment earnings and change in fair value of investments to the individual Plans, as reported on the *Statement of Changes in Net Assets Available for Benefits* for the year ended December 31, 2007; nor were we able to satisfy ourselves as to the allocation of these amounts by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the allocation of investment earnings and change in fair value to the Plans, the financial statements referred to in the first paragraph above present fairly, in all material respects, the Plans' net assets available for benefits as of December 31, 2007, and the changes in net assets available for benefits for the year then ended in conformity with accounting principles generally accepted in the United States of America.

## **Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Department's internal control over the Plans' financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing our opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Department's ability to initiate, authorize, record, process, or report the Plans' financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Plans' financial statements that is more than inconsequential will not be prevented or detected by the Department's internal control. We consider the deficiency described in the Finding and Recommendation section of this report to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the Plans' financial statements will not be prevented or detected by the Department's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we do not believe the significant deficiency described above is a material weakness.

## **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Plans' financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to Department management in a separate letter dated September 30, 2008.

This report is intended solely for the information and use of Plan stakeholders including participants, Department management and staff, third-party record-keepers and custodians/trustees, and those charged with governance, and is not intended to be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

***Original signed by***

David Botelho, CPA  
Chief, Office of State Audits and Evaluations

September 30, 2008



**Department of Personnel Administration  
Savings Plus Plans  
Statement of Net Assets Available for Benefits  
As of December 31, 2007  
(Amounts in Thousands)**

	<u>457 Plan</u>	<u>401(k) Plan</u>	<u>Part Time Seasonal/Temp Program</u>	<u>Alternate Retirement Program</u>	<u>Totals</u>
Short-Term Investments					
Short-Term Investment Fund-Cash	\$ 921,048	\$ 360,251	\$ -	\$ -	\$1,281,299
Short-Term Investment Fund	<u>454,872</u>	<u>191,403</u>	<u>68,559</u>	<u>47,919</u>	<u>762,753</u>
<b>Subtotal</b>	<b>1,375,920</b>	<b>551,654</b>	<b>68,559</b>	<b>47,919</b>	<b>2,044,052</b>
Bond Funds					
Bond Index Fund	194,539	153,971	-	-	348,510
Bond Fund	<u>1,447</u>	<u>1,114</u>	<u>-</u>	<u>-</u>	<u>2,561</u>
<b>Subtotal</b>	<b>195,986</b>	<b>155,085</b>	<b>-</b>	<b>-</b>	<b>351,071</b>
Equities-Passively Managed					
Asset Allocation Index Fund-Aggressive	23,731	24,328	-	-	48,059
Asset Allocation Index Fund-Conservative	12,073	8,195	-	-	20,268
Asset Allocation Index Fund-Moderate	207,982	190,797	-	-	398,779
Asset Allocation Index Fund-Moderately Aggressive	36,451	41,876	-	-	78,327
Asset Allocation Index Fund-Moderately Conservative	19,084	12,003	-	-	31,087
International Index Fund	7,904	7,803	-	-	15,707
Large Cap Index Fund	507,690	461,424	-	-	969,114
Mid Cap Index Fund	3,732	3,794	-	-	7,526
Small Cap Index Fund	<u>2,528</u>	<u>2,565</u>	<u>-</u>	<u>-</u>	<u>5,093</u>
<b>Subtotal</b>	<b>821,175</b>	<b>752,785</b>	<b>-</b>	<b>-</b>	<b>1,573,960</b>
Equities-Actively Managed					
International Fund	260,841	249,384	-	-	510,225
Large Cap Fund	630,084	552,648	-	-	1,182,732
Socially Responsible Fund	30,095	28,920	-	-	59,015
Mid Cap Fund	468,621	429,986	-	-	898,607
Small Cap Fund	<u>130,507</u>	<u>128,864</u>	<u>-</u>	<u>-</u>	<u>259,371</u>
<b>Subtotal</b>	<b>1,520,148</b>	<b>1,389,802</b>	<b>-</b>	<b>-</b>	<b>2,909,950</b>
Other Assets					
Schwab Personal Choice Retirement Account	175,003	141,253	-	-	316,256
Participant Loan Account	<u>28,762</u>	<u>31,855</u>	<u>-</u>	<u>-</u>	<u>60,617</u>
<b>Subtotal</b>	<b>203,765</b>	<b>173,108</b>	<b>-</b>	<b>-</b>	<b>376,873</b>
Contributions Receivable	<u>24,119</u>	<u>27,923</u>	<u>834</u>	<u>1,981</u>	<u>54,857</u>
<b>Gross Assets Available for Benefits</b>	<b>4,141,113</b>	<b>3,050,357</b>	<b>69,393</b>	<b>49,900</b>	<b>7,310,763</b>
Less: Accrued Fund Expenses	<u>2,389</u>	<u>2,164</u>	<u>54</u>	<u>7</u>	<u>4,614</u>
<b>Net Assets Available for Benefits</b>	<b><u>\$4,138,724</u></b>	<b><u>\$3,048,193</u></b>	<b><u>\$69,339</u></b>	<b><u>\$49,893</u></b>	<b><u>\$7,306,149</u></b>

The accompanying notes are an integral part of this financial statement.

**Department of Personnel Administration  
Savings Plus Plans  
Statement of Changes in Net Assets Available for Benefits  
For the Period January 1, 2007 to December 31, 2007  
(Amounts in Thousands)**

	<u>457 Plan</u>	<u>401(k) Plan</u>	<u>Part Time Seasonal/Temp Program</u>	<u>Alternate Retirement Program</u>	<u>Totals</u>
<b>ADDITIONS TO NET ASSETS</b>					
Net Investment Income					
Investment Earnings	\$ 33,069	\$ 27,062	\$ 2,027	\$ -	\$ 256,766 <sup>1</sup>
Change in Fair Value	<u>218,874</u>	<u>162,605</u>	<u>489</u>	<u>1,724</u>	<u>189,084<sup>1</sup></u>
Subtotal	251,943	189,667	2,516	1,724	445,850
Principal Additions					
Deferrals of Compensation	265,523	313,793	21,297	23,621	624,234
Transfers-In	<u>35,223</u>	<u>20,420</u>	<u>107</u>	<u>13</u>	<u>55,763</u>
Subtotal	300,746	334,213	21,404	23,634	679,997
<b>Total Additions</b>	<b>552,689</b>	<b>523,880</b>	<b>23,920</b>	<b>25,358</b>	<b>1,125,847</b>
<b>DEDUCTIONS FROM NET ASSETS</b>					
Withdrawals	249,601	93,892	6,474	676	350,643
Transfers-Out	78,042	67,434	11,885	22	157,383
Participant Asset-Based Fees	2,817	2,643	-	-	5,460
Fund Expenses	<u>7,713</u>	<u>5,661</u>	<u>53</u>	<u>7</u>	<u>13,434</u>
<b>Total Deductions</b>	<b>338,173</b>	<b>169,630</b>	<b>18,412</b>	<b>705</b>	<b>526,920</b>
<b>Increase in Net Assets</b>	<b>214,516</b>	<b>354,250</b>	<b>5,508</b>	<b>24,653</b>	<b>598,927</b>
NET ASSETS AVAILABLE FOR BENEFITS, January 1, 2007	<u>3,924,208</u>	<u>2,693,943</u>	<u>63,831</u>	<u>25,240</u>	<u>6,707,222</u>
<b>NET ASSETS AVAILABLE FOR BENEFITS, December 31, 2007</b>	<b><u>\$4,138,724</u></b>	<b><u>\$3,048,193</u></b>	<b><u>\$ 69,339</u></b>	<b><u>\$ 49,893</u></b>	<b><u>\$7,306,149</u></b>

The accompanying notes are an integral part of this financial statement.

<sup>1</sup> Amounts do not cross-foot. See Independent Auditor's Report.

# NOTES TO FINANCIAL STATEMENTS

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## **Note 1: Description of Reporting Entity and Significant Accounting Policies**

The accompanying financial statements present information on the financial activities of the Savings Plus Plans (Plans), comprising four separate defined contribution plans, relative to total assets held in trust for the benefit of Plan participants. Chapter 1370, Statutes of 1972 authorized the establishment of a deferred compensation plan for officers and employees of the State of California. The California Department of Personnel Administration (Department) administers the Plans and is the accountable reporting entity.

These financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America (GAAP).

The following Notes provide general information. For a complete description of the Plans' provisions, refer to the respective Plan documents and other *Forms and Publications* on the Department's website at <http://www.sppforu.com>.

## **Note 2: Plan Descriptions**

The Deferred Compensation Plan, Section 457 of the Internal Revenue Code (IRC), is a single-employer long-term savings plan. The 457 Plan was established in 1974 under Section 19993, Chapter 4 (Deferred Compensation), of the California Government Code (GC).

The Thrift Plan, Section 401(k) of the IRC, is also a single-employer long-term savings plan. The 401(k) Plan was established under Section 19999.5, Chapter 9 (Tax Deferred Savings Plans), of the GC.

The Alternate Retirement Program (ARP) was established in 2004 under Section 401(a) of the IRC and authorized by Section 19999.3 of the GC. The ARP was designed as a retirement savings plan in lieu of retirement benefits under the California Public Employees' Retirement System (CalPERS) during the first 24 months of state employment.

The Part-Time, Seasonal, and Temporary Employees' Retirement Program (PST) was established in 1991 under Section 457 of the IRC and authorized by Section 19999.2 of the GC. The PST Program was implemented as a result of the 1990 Federal Omnibus Budget Reconciliation Act, and its purpose is to provide a retirement savings program for employees who are not covered by CalPERS or Social Security.

All compensation is deferred under these Plans; and all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are held in trust for the exclusive benefit of Plan participants. The state does not make any contributions to the Plans.

*Deferrals of Compensation.* In 2007, 401(k) and 457 Plan participants were allowed to contribute up to \$15,500 of “includible compensation” to each Plan (as defined in the IRC). In 2007, under the Plans’ *Age-Based Deferral* provisions, an employee who is 50 years or older was permitted to contribute up to \$20,500 annually to each Plan.

In addition, the *457 Plan Catch-Up* provision allowed up to twice the annual 457 Plan contribution limit (\$31,000) for the 2007 and 2008 tax years. The maximum Catch-up amount cannot exceed the total amount under-contributed to all Plans in prior years. Further, participants cannot participate in both the 457 Age-Based Deferral and the Catch-up provision.

State law established the pre-tax amounts to be deducted from ARP and PST Program participants. Under the ARP, five percent of pre-tax wages in excess of \$513 may be deducted per month. The actual deductions vary depending on bargaining unit. Under the PST Program, 7.5 percent of a participant’s gross pay is deductible for program contributions.

*Participant Accounts.* Each participant’s account is credited with the participant’s contribution and accrues its pro rata share of any income, gains, losses, and administrative costs attributable to selected investments. At December 31, 2007 the number of Plan participants with account balances was as follows:

<u>Plan</u>	<u>Number of Participants with Account Balances</u>
457 Plan	98,782
401(k) Plan	93,785
ARP	24,560
PST Program	<u>106,503</u>
Total Participant Accounts	<u>323,630</u>

*Vesting.* A participant’s interest in his/her account is fully vested upon initial contribution.

*Payment of Benefits.* 401(k) Plan participants are eligible to receive benefits without a tax penalty upon attainment of age 59-1/2 (if still employed), upon retirement at age 55 or older, for financial hardship, or for beneficiaries upon their death. The 457 Plan participants are eligible to receive benefits without penalty upon termination of state employment, retirement, financial hardship, or for beneficiaries upon their death.

The 457 Plan participants can make in-service distributions of inactive accounts with a value of \$5,000 or less. To be eligible for this distribution, the participant cannot have made any 457 Plan contributions in 24 months, or received a prior distribution under this provision.

*401(k) and 457 Plan Termination.* Subject to applicable law, the Plans may terminate on any date specified by the state with thirty (30) days advance written notice to the Department and all participants. Upon termination or partial termination of these Plans, the rights of all affected participants, beneficiaries, and alternate payees/account holders to benefits accrued at the date of such termination cannot be forfeited. The Department shall make all adjustments and distributions as required under the Plans.

### **Note 3: Investments**

The Department changed the investment options structure in November 2007 to one that provided 401(k) and 457 Plan participants a portfolio of both actively and passively managed funds. Nine *funds of funds* options were added comprising five passively managed risk-based asset allocation funds and four actively managed equity funds. In addition, the structure included five index funds, a variable annuity product, a mutual fund bond option, two short-term investment funds, and a self-directed brokerage account provided through Charles Schwab, Inc. For purposes of this report, these asset categories are individually and collectively referred to as “Fund” or “Funds.”

*Loan Program.* Participants may borrow from their 401(k) and 457 accounts for general purpose and primary residence loans. The minimum and maximum loan amounts are \$5,000 and \$50,000, respectively. The loans are secured by the balance in the participant's account. The loan interest rate is calculated as the prime rate plus one percent.

The Department maintains ARP and PST assets in the *Short-Term Investment Fund (STIF)* managed by Dwight Asset Management Company (Dwight).

#### Investment Valuation

Securities are stated at fair value. Securities traded on U.S. securities exchanges or in the NASDAQ Stock Market, Inc., are valued at the regular trading session closing price in the exchange or market in which such securities are traded. If any security is not traded on a valuation date, it is valued at the most recent quoted bid price. Over-the-counter securities not reported in NASDAQ are also generally valued at the most recent quoted bid price. However, fixed income securities may be valued on the basis of evaluated prices provided by independent pricing services when such prices are believed to reflect the fair market value of those securities. Such prices may be determined from securities prices, yields, maturities, call features, ratings, institutional size trading in similar groups of securities, and developments related to specific securities. Short-term investments are valued at amortized cost. Repurchase agreements are valued at cost, which approximates fair value. Certain investments may be valued based on quotations received from independent brokers. Investments in Other Funds are valued at the applicable unit value of those Funds. Any securities for which no current market quotation is readily available are valued at fair value as determined in good faith by the investment manager. The investment manager, at its discretion, may make adjustments to the prices of securities held by a Fund if an event occurs after the publication of market values normally used by a Fund, but before the Fund's net asset value is calculated, depending on the nature and significance of the event.

#### Investment Transactions and Investment Income

Investment transactions are accounted for on a trade date basis (date the order to buy or sell is executed). The Funds' realized gains or losses from investment transactions are determined on the average cost basis. Dividend income is recorded on the ex-dividend date. Interest income and expenses are recorded on the accrual basis. Interest income includes the amortization of premiums and accretion of discounts using the effective yield method on fixed income securities.

Earnings accrue to individual participant accounts based on the performance of selected investment options. On a daily basis, administrative, custodial, and investment manager expenses are accrued and deducted before calculating the participants' net asset value.

#### **Note 4: Short-Term Investment Fund (STIF)**

The Short-Term Investment Fund (STIF) consists of money market funds, collective investment trusts (see Note 5), and investment contracts.

##### Description of Investment Contracts

The STIF primarily invests in asset contracts such as guaranteed investment contracts (GICs) issued by insurance companies and other financial institutions, and synthetic GICs with similar characteristics.

Traditional GICs are backed by the general account of the issuer. The Fund deposits a lump sum with the issuer and receives a guaranteed interest rate for a specified period. Interest is accrued on either a simple interest or fully compounded basis, and paid either periodically or at the end of the contract term. The issuer guarantees that all qualified participant withdrawals will occur at contract value (principal plus accrued interest).

Synthetic GICs are investment contracts (also referred to as wrap or wrapper contracts) issued by an insurance company or bank, and backed by a portfolio of bonds owned by two collective trust funds. The assets underlying the wrap contract are maintained separate from the issuer's general assets, usually by a third party custodian. The wrap contracts are obligated to provide an interest rate not less than zero. These contracts typically provide that realized and unrealized gains and losses on the underlying assets are not reflected immediately in the net assets of the Fund, but are amortized over the maturity period or duration of the underlying investments, via adjustments to the future interest crediting rate. The issuer guarantees that all qualified participant withdrawals will occur at contract value.

The STIF is managed by Dwight. After the November 2007 portfolio restructure, the various Asset Allocation Index Funds were invested in the STIF as follows: Conservative—60% invested in STIF; Moderately Aggressive—40%; Moderate—25%; and Moderately Aggressive—5%. The total value of STIF assets is not separately identified on the Statement of Net Assets Available for Benefits, but is contained within the aforementioned Asset Allocation Index Funds.

The following schedules present the reconciliation of total STIF assets from fair value to contract value and the average earnings yield for the year ended December 31, 2007:

##### Fair Value to Contract Value Reconciliation (in 000s)

Investments at Fair Value	\$887,360
Less: Accrued Fund Expenses	<u>331</u>
Net Assets at Fair Value	887,029
Add: Adjustments to Fair Value	<u>2,061</u>
Net Assets at Contract Value	<u>\$889,090</u>

Average Earnings Yield (in 000s)

	<u>Annual Earnings</u>	<u>Fair Value of Contracts</u>	<u>Average Yield</u>
Traditional GICs	\$ 2,032	\$ 48,517	4.19%
Synthetic GICs	28,805	710,906	4.05%
Money Market Funds	490	15,026	4.99%
Collective Trusts	<u>3,106</u>	<u>112,911</u>	N/A
Total	<u>\$34,433</u>	<u>\$887,360</u>	

Variables Impacting Interest Crediting Rates

The primary variables impacting future interest crediting rates of synthetic GICs include: (1) current yield of the assets within the wrap contract, (2) duration of the assets covered by the wrap contract, and (3) existing difference between the market value and contract value of the assets within the wrap contract. Traditional fixed-rate GICs do not experience fluctuating crediting rates.

The Fund uses two generally accepted crediting rate calculations for synthetic GICs, taking into account the market value of the underlying bonds, contract value, weighted average duration of the portfolio, and weighted average yield to maturity of the underlying bonds. The net crediting rate reflects fees paid to synthetic contract issuers. Contract crediting rates typically reset quarterly but cannot be less than zero percent. Traditional GICs provide a fixed or floating rate of interest over the contract term.

The crediting rate of synthetic contracts will track current market yields on a trailing basis. Specifically, the quarterly rate reset allows the contract value of the portfolio to converge to the market value over time, assuming the market value continues to earn the current portfolio yield for a period of time equal to the current portfolio duration.

Termination of Contracts at Amounts Different than Contract Value

Traditional GICs generally do not permit issuers to terminate the contract prior to maturity date. However, synthetic GICs may contain specific termination provisions. These wrap contracts permit the Fund's investment manager or issuer to terminate upon notice at any time at market value, and also provide for automatic termination of the wrap contract if the book value or market value of the contract equals zero. The issuer is not excused from paying the excess contract value when the market value equals zero. Wrap contracts that permit the issuer to terminate at market value generally provide that the Fund may elect to convert such termination to an amortization election, as described below. In addition, if the Fund defaults in its obligations under the contract, including the issuer's determination that the agreement constitutes a non-exempt prohibited transaction as defined under the Employee Retirement Income Security Act of 1974 (ERISA), and such default is not cured within the time permitted by any cure period, then the wrap contract may be terminated by the issuer and the Fund will receive the market value as of the date of termination. Also, wrap contracts generally permit the issuer or investment manager to elect at any time to convert the wrapped portfolio to a declining duration strategy, whereby the contract would terminate at a date which corresponds to the duration of the underlying fixed income portfolio on the date of the amortization election.

After the effective date of an amortization election, the fixed income portfolio must conform to the guidelines agreed upon by the wrap issuer and the investment manager for the amortization election period. Such guidelines are intended to result in the contract value equaling the market value of the wrapped portfolio on the termination date.

## Note 5: Collective Trusts

Collective Trusts (CTs) managed by Dwight are included in the STIF. Other investment options, including the five index funds, are also invested in CTs managed by Northern Trust Global Investments (NTGI).

Unlike mutual funds, CTs are not required to register with the SEC as investment companies under the Investment Company Act of 1940. Consequently, CTs are not subject to the same regulation as mutual funds, such as the requirement to issue a prospectus. CTs are sponsored and maintained by a bank trust department or a trust company. The CTs operate under the supervision of the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC) pursuant to OCC Regulation 9.18. Additional rules and regulations promulgated by the Securities and Exchange Commission (SEC) and the U.S. Department of Labor (DOL) provide guidance on the operation of collective trusts. DOL Regulation 2520.103-5(c) requires that an annual statement of assets and liabilities of the collective trust be provided to the plan administrator. NTGI certified that the information contained in its annual report is accurate and complete pursuant to Regulation 2520.103-5(d).

The following table presents the percentage of asset allocation funds and actively managed funds within the corresponding NTGI CT fund:

	NTGI Collective Trust				
	A	B	C	D	E
<u>Asset Allocation Funds</u>					
Conservative	20%	9.75%	3%	2.25%	5%
Moderately Conservative	20%	19.5%	6%	4.5%	10%
Moderate	15%	26%	8%	6%	20%
Moderately Aggressive	15%	35.75%	11%	8.25%	25%
Aggressive	5%	42%	13%	10%	30%
<u>Actively Managed Funds</u>					
Large Cap Equity	0%	10%	0%	0%	0%
Mid Cap Equity	0%	0%	10%	0%	0%
Small Cap Equity	0%	0%	0%	10%	0%
International Equity	0%	0%	0%	0%	10%

A = Quantitative Management (QM) Collective Daily Aggregate Bond Index Fund\*

B = QM Collective Daily S&P 500 Equity Index Fund\*

C = QM Collective Daily S&P Mid Cap 400 Equity Index Fund\*

D = QM Collective Daily Russell 2000 Equity Index Fund – Class C\*

E = QM Collective Daily Europe, Australasia, and Far East (EAFE) Index Fund\*

\*Lending Funds

## Note 6: Service Agreements

The Department contracts with Nationwide Retirement Solutions, Inc., for Plan record keeping services and with JP Morgan Chase Bank, N.A., for investment custody and trust accounting services. In addition, the Department contracts with Northern Trust Investments, N.A., Dwight Asset Management Company, Inc., and other entities for investment management and legal services.



## **Note 7: Account Fees**

During 2007 the 401(k) and 457 Plan participants paid monthly account maintenance fees based on their respective asset levels for each Plan. The fees ranged between \$2.00 and \$4.05 and were based on a five-tier flat-fee structure assessed on the market value of the account on the assessment date. The fee was prorated to all investment options held in the account. As such, these are referred to as "Participant Asset-Based Fees." As of January 1, 2008 the fee structure is a flat fee of \$1.50 per month, per Plan.

## **Note 8: Accrued Fund Expenses**

On a daily basis JP Morgan accrues incremental amounts of Plan administrative fees, trustee/custodial fees, and investment manager fees. These amounts are deducted prior to calculation of the daily net asset value (i.e., the daily unitized value reported to Plan participants). The Plans' financial statements reflect accruals of fund expenses incurred but not paid as of December 31, 2007.

## **Note 9: Governmental Accounting Standards Board (GASB) No. 40 Disclosures**

### Investment Policies

This section describes the Plans' authorized investments, credit risk, interest rate risk, custodial credit risk, and foreign currency risk.

### Authorized Investments

Section 16431(a) of the GC provides that the Funds may be invested in the types of investments set forth in Sections 53601 and 53602, and may additionally be invested in corporate stocks, bonds, securities, mutual funds, savings and loan accounts, credit union accounts, annuities, mortgages, deeds of trust, or other security interests in real or personal property. Deferred compensation funds are public pension or retirement funds for the purposes of Section 17, Article XVI, of the California Constitution.

Section 53601 of the GC allows for the delivery of purchased securities to a third-party custodian. This Section further allows for investments in local agency bonds, U.S. Treasury notes, bonds, bills, or certificates of indebtedness; registered state warrants or treasury notes and bonds; registered treasury notes or bonds of other states; bonds, notes, or warrants of any California local agency; federal agency obligations; and participation, bankers' acceptances, commercial paper of prime quality, and negotiable certificates of deposit (CDs) by national or state-chartered banks and savings associations. Investments may also include repurchase agreements, reverse purchase agreements, securities lending agreements, medium term notes corporate debt securities, and financial futures or financial option contracts in any of the preceding categories.

Although the Plans are exempt from the provisions of Section 3(32), Title I, of ERISA, the Department generally follows the fiduciary best practices as outlined in ERISA.

The Plans' *Investment Policy Statement (IPS)* indicates that investment vehicles may consist of mutual funds, commingled investment trusts, and separate accounts and annuities. Investments made through mutual funds, commingled investment trusts, and annuities are governed by the Fund's investment guidelines outlined in the fact sheet/prospectus, trust

agreement, and group annuity contract, respectively. The IPS also states that an investment manager agreement (IMA) shall be established for each separately managed account in order to specify investment guidelines and objectives for that account.

#### Investments Authorized by Debt Agreements

Except for the brokerage account, Plan investment options do not include individual bond issuances. Bond exposure is limited to open-end investment options provided through Western Asset Management Company and to the STIF Synthetic GICs. Northern Trust Investments, N.A., handles the passively-managed bond funds through a commingled trust.

#### Credit Risk and Interest Rate Risk

The Bond Fund, Northern Trust Global Investments (NTGI) Bond Index Fund, STIF cash, and STIF synthetic GIC investment options are exposed to credit risk and interest rate risk. Also, the STIF and money market component of several investment options are subject to such risk.

The following table depicts the value at year-end of investments subject to credit and interest rate risk with corresponding interest rates. These investments are unrated. The Department selects the weighted average maturity as its primary mechanism for reporting interest rate risk for synthetic investment contracts.

#### Investment Options Subject to Credit/Interest Rate Risk (in 000s)

<u>Investment Option</u>	<u>Value at Year-End</u>	<u>Interest Rate at Year-End</u>
STIF Synthetic Investment Contracts	\$710,906	4.05%
Bond Fund (a)	2,562	N/A
NTGI Bond Index Fund (b)	431,804	N/A
STIF Cash (c)	1,281,299	5.02875%
JP Morgan Liquid Assets Money Market Fund	53,198	4.99%

- (a) Western Asset Core Plus Bond Portfolio *Bond Fund* is an actively managed mutual fund (Ticker: WACPX) provided by Western Asset Management Company.
- (b) NTGI Bond Index Fund is part of the Bond Index Fund and Asset Allocation Funds.
- (c) STIF-Cash includes City National Bank (City National) and Washington Mutual Bank, F.A. (WaMu) funds, with crediting interest rate based on the 3-month London Interbank Offered Rate (LIBOR) of the preceding quarter adjusted by 20 basis points.

#### Custodial Credit Risk

The Plans' policy for custodial credit risk requires that deposits in *Short Term Investment Fund—Cash* held by City National and WaMu be insured by the Federal Deposit Insurance Corporation (FDIC) (currently at \$250,000 per account per institution). Amounts held in excess of the \$250,000 FDIC limit are properly collateralized at 110 percent of the excess amount. At December 31, 2007, approximately \$4.3 million of participant assets representing 54 accounts required collateralization.

### Foreign Currency Risk

The following amounts are included within the *International Fund* and are managed by Alliance Bernstein (international value strategy) and McKinley Capital Management, Inc. (international growth strategy). The assets are held in separate accounts.

<u>Foreign Currency Denomination</u>	<u>U.S. Dollar Equivalent (in 000s)</u>
Australian Dollar	\$ 9,299
British Pound	83,634
Canadian Dollar	4,888
Czech Republic Krona	2,793
Danish Krone	6,418
European Union Euro	179,019
Hong Kong Dollar	23,984
Japanese Yen	77,320
Norwegian Krone	1,145
Swedish Krona	2,898
Swiss Franc	19,091
South African Rand	3,524
Total	<u>\$414,013</u>

In addition, \$171.2 million was invested in the Northern Trust Global Investments EAFE Fund, a commingled trust instrument. The *International Index Fund*, *Asset Allocation Index Funds*, and *International Fund* are invested in this commingled trust.

### **Note 10: Related Party Transactions**

GASB requires disclosure of Plan transactions and assets handled by the same entity as custodian, manager, or record-keeper, and the related compensation.

### Nationwide Retirement Solutions

Nationwide Funds Group (formerly Nationwide Mutual Funds) managed the following Funds until November 7, 2007. Both Nationwide Retirement Solutions (the Plans' record keeper) and Nationwide Funds Group are subsidiaries of Nationwide Financial Services, Inc., the parent company.

<u>Asset Allocation Funds</u>	<u>Asset Value (in 000s) at November 7, 2007</u>	<u>Fund Expense (Annualized)</u>
Conservative Fund	\$ 17,837	0.48%
Moderately Conservative Fund	25,254	0.48%
Moderate Fund	394,846	0.44%
Moderately Aggressive Fund	74,557	0.48%
Aggressive Fund	44,342	0.49%
Total	<u>\$556,836</u>	

## JP Morgan Chase

Various subsidiaries or divisions of JP Morgan Chase & Co. provided Plan services. JP Morgan Worldwide Securities Services, a division of JP Morgan Chase Bank, N.A., provided investment custody and trust accounting services to the Plans. JP Morgan Investment Advisors, Inc., managed \$53.2 million of Plan funds invested in the *JP Morgan Liquid Assets Money Market Fund* at December 31, 2007. These funds were included in the various investment options offered to Plan participants. The Fund expense ratio was 45 basis points (0.45 percent) on an annualized basis.

### **Note 11: Subsequent Events**

- A. As of January 1, 2008, the *Short-Term Investment Fund—Cash* no longer accepts additional moneys (i.e. current deferrals, transfers, or exchanges).
- B. American International Group, Inc. (AIG) is a wrap provider to approximately \$155 million of the total Synthetic GIC fair value disclosed in Note 4. As of September 29, 2008, AIG was rated A2 by Moody's, and the rating is on negative watch. The Dwight-managed fixed income portfolios that are covered by the AIG wraps continue to have an average quality of AAA. The Department does not believe the current situation poses any risk of loss to Plan participants and it still considers these investment contracts to be fully benefit-responsive.
- C. On September 25, 2008, the U.S. Department of the Treasury, Office of Thrift Supervision (OTS), closed Washington Mutual, Inc. (WaMu), and appointed the FDIC as receiver. WaMu's banking operations were sold in a transaction facilitated by the OTS and the FDIC. The FDIC ran the bidding process that resulted in the decision to sell the banking operations to JP Morgan Chase Bank, N.A. As disclosed in Note 9, *STIF-Cash* funds were invested with WaMu. The Department has concluded there will be no impact to Plan participants.

## FINDING AND RECOMMENDATION

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### **FINDING 1: Income was Not Properly Allocated to the Plans**

For the year ended December 31, 2007, the Department did not properly report investment earnings and change in fair value of investments to the individual Plans. Although the total amounts of \$256.7 million and \$189 million, respectively, and the net asset balances were fairly stated, the allocation of these amounts to earnings and change in fair value within the individual Plans was incomplete. Specifically, JP Morgan Chase does not allocate or report the State of California Master Trust assets by Plan type, including investment gains and losses (realized and unrealized) and earnings (dividends, etc.) as required by the Trust Agreement. As a result, Nationwide Retirement Solutions (NRS) could not provide complete and accurate information on earnings, gains, and losses by Plan. The Department is currently working with NRS to develop an equitable allocation methodology and documentation process, and with JP Morgan Chase to establish adequate accounting and reporting mechanisms at the individual Plan level.

**Recommendation:** Ensure that all Plan transactions, including the allocation of investment earnings and change in fair value of investments, are separately and accurately reported for each Plan.



**DEPARTMENT OF PERSONNEL ADMINISTRATION**

OFFICE OF THE DIRECTOR  
1515 "S" STREET, NORTH BUILDING, SUITE 400  
SACRAMENTO, CA 95814-7243



October 27, 2008

David Botelho, CPA  
Chief, Office of State Audits and Evaluations  
Department of Finance  
915 L Street  
Sacramento, CA 95814

Dear Mr. Botelho;

I thank the members of the audit team for their work performed to produce the recently delivered: A Financial Statement Audit (September 2008). Staff in the Savings Plus Program (SPP) reviewed this audit report along with your staff. SPP staff concurs with the results and conclusions.

At the exit interview, conducted on Thursday October 16, SPP and audit team staff discussed in detail the single Finding contained in this report (page 16). SPP staff acknowledges the Finding is accurate.

SPP staff are currently working with our Third Party Administrator, Nationwide Retirement Solutions, to amend how earnings activities are categorized. We hasten to reiterate, as the auditors have concluded, the total investment earnings and changes in fair value were properly and accurately stated. Your audit team also concluded the net asset balances were fairly stated at December 31, 2007.

We commend the audit team for their thoroughness and diligence in this financial examination. We will continue to ensure that assets are properly safeguarded and available for the exclusive benefit of our participants and their beneficiaries.

Sincerely,

Original signed by:

David A. Gilb  
Director